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March 16, 2006

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station, 2nd Floor
Boston, MA 02110

Re: Request for Approval of Natural Gas Asset Optimization Service Contract, D.T.E. 06-9

Dear Secretary Cottrell:

Filed herewith is the Initial Brief of KeySpan Energy Delivery New England ("KeySpan") in the above-referenced proceeding.

Thank you for your consideration and assistance in this matter.

Very truly yours,

Cheryl M. Kimball

Enclosures

cc: Service List

COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

KeySpan Energy Delivery New England	)	D.T.E. 06-9

INITIAL BRIEF OF KEYSPAN ENERGY DELIVERY NEW ENGLAND

I. INTRODUCTION

On January 30, 2006, Boston Gas Company, Colonial Gas Company and Essex Gas Company, each d/b/a/ KeySpan Energy Delivery New England (collectively, "KeySpan" or "Company") submitted for approval by the Department of Telecommunications and Energy ("Department") under G.L. c. 164, § 94A, a Natural Gas Asset Optimization Service Contract (the "Asset Optimization Agreement" or "Agreement") between KeySpan Corporate Services LLC ("KSCS") (as agent for KeySpan) and Merrill Lynch Commodities Inc. ("MLCI"). The Department previously approved a similar asset management agreement with MLCI in KeySpan Energy Delivery, D.T.E. 04-9 (2004).[1] The Company's proposal was docketed as D.T.E. 06-9.

On February 27, 2006, pursuant to notice duly issued, the Department conducted a public hearing to afford interested persons the opportunity to comment on KeySpan's proposal. The Attorney General of the Commonwealth (the "Attorney General") intervened as of right pursuant to G.L. c. 12, § 11E.

[1] The contract approved in D.T.E. 04-9 was between KeySpan and Entergy-Koch Trading, LP, which now operates as MLCI (Exh. EDA-1, at 16). In this brief, the existing agreement with MLCI will be referred to as the "EKT Agreement".

On March 13, 2006, the Department conducted an evidentiary hearing. The Company presented the testimony of Elizabeth D. Arangio, director of gas supply planning. Pursuant to the procedural schedule, the Company and the Attorney General filed initial briefs on March 16, 2006. Reply briefs are due March 21, 2006. The evidentiary record consists of 36 exhibits and one response to a record request issued by the Department.

II. DESCRIPTION OF THE FILING

A. Request for Proposals Process

On June 17, 2005, KeySpan issued a request for proposals ("RFP") to 23 wholesale gas marketers to both manage its resource portfolio and to provide city-gate supply to KeySpan's sales customers (Exh. EDA-1, at 13; Exh. KED-DTE-1-2; Exh. KED-AG-1-1, at 12). In order to ensure a fair, open and transparent process, the RFP requested that all bidders submit questions relating to the RFP in writing to the Company's designated representative (Exh. KED-AG-1-3; Exh. KED-DTE-1-2). KeySpan responded in writing to three rounds of questions from potential bidders (id.). Out of 23 parties solicited to participate in the RFP process, KeySpan received four bids by the July 29, 2005 deadline set by the Company (Exh. EDA-1, at 13; Exh. KED-AG-1-1). Each bid was evaluated based on five factors set forth in the RFP: (1) price; (2) experience; (3) flexibility; (4) number of contract exceptions proposed; and (5) creditworthiness (Exh. KED-AG-1-1; Exh. KED-AG-1-2). After a period of internal review, KeySpan commenced negotiations will all four bidders (Exh. EDA-1, at 13).

On September 7, 2005, and following the devastation in the Gulf by Hurricanes Katrina and Rita, KeySpan requested the four competitors to refresh their bids for two reasons: (1) to clarify the resources that would be available to the manager under the agreement; and (2) to identify whether the occurrence of the two hurricanes had any impact on the initial bids submitted to the Company (id.; Exh. KED-AG-1-6; Exh. KED-DTE-1-2; Tr. 28-29). KeySpan received the refreshed bids on September 13, 2005 (id.). After a period of internal review, the Company narrowed the field to two bidders, MLCI and the next highest bidder, and renewed negotiations with these entities (Exh. EDA-1, at 13; Exh. KED-AG-1-2 (supp.); Exh. KED-DTE-1-2; Exh. KED-DTE-1-6).

Following its receipt of the refreshed bids in September, and during negotiations with the two, short-listed bidders, KeySpan determined that the declining number of asset managers exhibiting a willingness and ability to manage KeySpan's Massachusetts portfolio, in combination with market circumstances, indicated a need to solidify its in-house capability to perform the critical operations involved in the asset-management function (Exh. EDA-1, at 15-17; Tr. at 28-29). After discussion with the two, short-listed bidders regarding the possibility of structuring the agreement as a co-management arrangement to facilitate the Company's effort to enhance its in-house capability, one of the short-listed bidders withdrew from negotiations (Exh. KED-DTE 1-2; Exh. KED-DTE-1-6; Tr. at 62-63). Therefore, based on the value offered for the asset-management arrangement and MLCI's willingness to enter into a co-management arrangement, KeySpan selected MLCI as the winning bidder (id.).

B. MLCI Agreement

The Asset Optimization Agreement provides that MLCI will work in conjunction with KeySpan to: (1) manage certain upstream interstate gas supply, transportation and underground storage assets of the Company; and (2) provide the city-gate supply requirements of the Company's sales customers (Exh. EDA-1, at 20-21; Exh. EDA-3, at Article II and III; Tr. at 38-39). From the perspective of customers, the Asset Optimization

Agreement would operate in the exact same manner as the existing outsourcing arrangement, with the exception that KeySpan would take an active role in day-to-day procurement and delivery activities, as well as the strategic transactions undertaken to derive value for customers (Exh. EDA-1, at 9-10; Exh. KED-DTE-1-5).

To accomplish the outsourcing arrangement, all or a portion of the Company's upstream transportation capacity and underground-storage assets will be released to MLCI and MLCI will have an obligation to deliver the MDQ associated with the assets released to it to meet the gas-supply requirements of KeySpan's firm sales customers (Exh. EDA-1, at 10-11; Exh. KED-DTE-1-5). Assets that are not released to MLCI will be managed under the Agreement by KeySpan. MLCI will work with KeySpan to handle day-to-day operational requirements, including the procurement of gas supplies, the scheduling and nominating of supplies, as well as all transactions undertaken to derive value from the portfolio assets (id.). KeySpan will have frequent contact with MLCI to map out strategies for utilizing and optimizing the portfolio assets (id.).

As with the current agreement, customers will receive the benefit of a guaranteed payment each year, which would be applied as a direct credit to customers through the CGAC (id. at 10; Exh. KED-DTE-1-3; Exh. KED-AG-1-7; Tr. at 13-15, 47). Any revenues derived through the use of the portfolio assets in excess of the guaranteed payment would be shared with KeySpan customers, except that KeySpan would share in the MLCI portion of the excess revenues (rather than the customer portion as is the case under the current agreement) (Exh. EDA-1, at 10, 24-25; Exh. KED-DTE-1-3; Exh. KED-AG-1-7). Customers will be ensured that they pay no more with the arrangement in place than they would in the absence of the agreement, because KeySpan would continue to be responsible for all demand charges associated with its pipeline and underground storage resources and commodity prices would be established based on the tiered pricing hierarchy associated with the Company's physical assets (Exh. EDA-1, at 10, 24-25; Exh KED-DTE-1-3; Tr. at 47-48).

By application of the pricing hierarchy, commodity charges will be calculated based on the market indices that correlate to the receipt points designated in the Company's resource contracts (id.). Thus, commodity charges would track the Company's dispatch of assets in the absence of the arrangement (id.). As a result, both capacity and commodity costs are linked to the Company's actual contract entitlements, thereby shielding customers from the risks of portfolio-optimization activities undertaken by the asset manager (id.).[2]

C. Allocation of Revenues Generated Under the Agreement

Under the terms of the Asset Optimization Agreement, MLCI and KeySpan would jointly guarantee a fixed minimum payment to customers (Exh. EDA-3, at Article VI; Tr. at 13-14). In addition to the minimum amount, customers would receive an allocation of any revenues generated in excess of the minimum amount (Exh. EDA-1 at 6, 10, 24; Exh. DTE 1-3; Exh. KED-AG-1-7; RR-DTE-1; Tr. at 13-14, 19-20). However, KeySpan would not share in the customer portion of excess revenues as it did under the existing agreement (id.). Instead, KeySpan would share the excess revenues that are retained by MLCI (id.). Under this arrangement, customers would receive a higher allocation of revenues than the existing agreement (because the customer portion is not shared with KeySpan); MLCI would receive a smaller portion of the revenues exceeding the fixed payment, and KeySpan would receive a

2 The Company also testified that the gas-purchasing plan approved by the Department in KeySpan Energy Delivery, D.T.E. 03-85 (2003), would not be affected by the Department's approval of the Agreeement because it operates separately from the management of the resource portfolio (Exh. EDA-1, at 25; Tr. at 54-55).

larger share of revenues exceeding the fixed payment in consideration of the higher level of risk and cost that would be incurred by KeySpan under the arrangement (RR-DTE-1).

III. STANDARD OF REVIEW

In evaluating a gas utility's resource options for the acquisition of commodity resources as well as for the acquisition of capacity under G.L. c. 164, § 94A ("Section 94A), the Department examines whether the acquisition of the resource is consistent with the public interest. Boston Gas Company, D.T.E. 04-9, at 9 (2004); Commonwealth Gas Company, D.P.U. 94-174-A, at 27 (1996). In order to demonstrate that the proposed acquisition of a resource that provide commodity and/or incremental resources is consistent with the public interest, an LDC must show that the acquisition: (1) is consistent with the company's portfolio objectives, and (2) compares favorably to the range of alternative options reasonably available to the company and its customers, including releasing capacity to customer migrating to transportation, at the time of the acquisition or contract negotiation. Id.

In establishing that a resource is consistent with the company's portfolio objectives, the company may refer to the portfolio objectives established in a recently approved forecast and requirements plan or in a recent review of supply contracts under Section 94A, or may describe its objectives in the filing accompanying the resource proposal. Id. In comparing the proposed resource acquisition to current market offerings, the Department examines relevant price and non-price attributes of each contract to ensure a contribution to the strength of the overall supply portfolio. Boston Gas Company, D.T.E. 04-9, at 10; Commonwealth Gas Company, D.P.U. 94-174-A, at 28. As part of the review of price and non-price attributes, the Department considers whether the pricing terms are competitive with those of the broad range of capacity, storage and commodity options that were available to the LDC at the time of the acquisition, as well as those opportunities that were available to other LDCs.

IV. The Company's Proposal Meets the Department's Standard for Approval of a Gas Supply Contract under G.L. c. 164, § 94A.

A. Request for Proposals Process.

The Asset Optimization Agreement is the product of a competitive solicitation process that was fair, open and transparent. The Company issued an RFP to a comprehensive list of wholesale gas marketers and conducted the process leading up to the bids in a fair and transparent manner because all substantive communications were made in writing and distributed to all parties on an equal basis (Exh. EDA-1, at 13; Exh. KED-DTE-1-2; Exh. KED-AG-1-1, at 12; Exh. KED-AG-1-3). The Company accepted two rounds of bids from all of the competitors that submitted bids as a result of the initial RFP process (id.).

The Company evaluated the bids based on a five-factor point system that placed a relatively higher priority on price, experience and creditworthiness (Exh. KED-DTE-1-2; Exh. KED-AG-1-2). As a result of this analysis, the Company developed a "short-list" of bidders comprised of the two entities that offered the highest value for a traditional outsourcing arrangement (Exh. EDA-1, at 13; Exh. KED-DTE-1-2; Exh. KED-AG-1-2 (supp.); Exh. KED-AG-1-3). After they were notified of their short-list status, the Company apprised both entities of its intention to change the structure of the arrangement (Tr. at 57-59). After several discussions regarding the details of this arrangement, the short-list entities were provided with the opportunity to revise their bids (Exh. EDA-1, at 13; Exh. KED-DTE-1-2; Exh. KED-AG-1-2; Tr. at 57-59). The Company did not apprise the two original bidders who were excluded from the short list of the change in structure because the bids submitted by these entities were priced well below the short-list bidders (in addition to other detracting features) and would have remained in that relative position even under a co-management arrangement (Exh. KED-AG-1-2; Tr. at 24, 57-59). Therefore, the Company selected MLCI for three reasons: (1) it offered the best value for customers under a co-management arrangement (Exh. KED-AG-1-2 (supp); (2) the Company's knowledge and experience with MLCI is that it is a reliable and creditworthy partner (Exh. EDA-1, at 14-15; Exh. KED-DTE-1-7); and (3) MLCI exhibited a willingness to enter into the Agreement as a co-management arrangement.

Accordingly, the evidence demonstrates that (1) the evaluation process was outlined for bidders in the RFP and later communications between the Company and bidders; (2) the Company provided bidders with evaluation criteria and applied the evaluation criteria throughout the bid-assessment process, and (3) the Company engaged in a process to provide written questions and answers to bidders, which allowed bidders to receive clarification and better understand the Company's objectives on a fair and objective basis. In addition, the bids were evaluated and the winning bidder was selected based on the criteria set forth in the RFP. The bidders raised no objection to the RFP process. Therefore, the Department should find that the RFP process conducted by KeySpan was fair, open, and transparent, and therefore, acceptable.

B. <u>Asset Optimization Agreement</u>

The proposed Asset Optimization Agreement meets the Department's standard for approval of a gas commodity contract for several reasons. Under the Department's standard, the Company must demonstrate that the contract is in the public interest because it: (1) is consistent with the Company's portfolio objectives; and (2) compares favorably to the range of alternative options reasonably available to the company and its customers.

1. Consistency with the Portfolio Objectives

With respect to the first part of the Department's standard, the Department found in D.T.E. 04-9 that the EKT Agreement was consistent with KeySpan's most recently approved forecast and supply plan filing, KeySpan Energy Delivery, D.T.E. 01-105 (2003), because the contract would replace an existing supply source and did not constitute an "incremental" supply source not covered by the plan (D.T.E. 04-9, at 11). In this case, the Asset Optimization Agreement would replace the existing EKT Agreement, and therefore, would replace an existing supply source rather than constituting an incremental supply source. In addition, the contracts subject to the arrangement are the same bundle of contracts reviewed and approved by the Department in D.T.E. 01-105 and KeySpan Energy Delivery, D.T.E. 03-66 (2003), as well as being those encompassed in the Company's most recent long-range resource and requirements plan, which is currently pending before the Department in KeySpan Energy Delivery, D.T.E. 05-68.[3] Moreover, the Asset Optimization Agreement is designed with the specific intent of meeting the critical portfolio objectives of flexibility, reliability and diversity of supplies.

In terms of the flexibility, reliability and diversity of supplies, the Department has consistently required LDCs to develop both price and non-price criteria to be used in evaluating new contracts. See, e.g., Boston Gas Company, 25 DOMSC 116, at 271 (1992).

> In determining whether a gas supply or capacity contract compares favorably to the range of alternative options reasonably available, the Department must consider both price and non-price attributes as part of a comprehensive assessment of the proposed contract.

[3] This includes KeySpan's contract with Tennessee Gas Pipeline Company relating to the ConneXion Project, which was approved by the Department in KeySpan Energy Delivery, D.T.E. 05-35 (2006).

Bay State Gas Company, D.T.E. 98-79, at 6 (1998). In particular, flexibility and diversity of the overall resource portfolio are important non-price criteria evaluated as part of the approval process because these attributes allow an LDC to respond to a range of future (and unforeseen) conditions, and therefore, to ensure the reliability of the resource portfolio. 25 DOMSC 116, at 272. Thus, the Department has consistently found that an LDC will meet its firm sales requirement in a least-cost manner when it also achieves the requisite level of reliability, diversity and flexibility. Colonial Gas Company, D.P.U. 96-93, at 7-8 (1997).

In this case, the record shows that the additional technical resources and qualified staff must be trained and experienced with transactions involving the Massachusetts portfolio in order to ensure optimal management of the portfolio in the absence of a qualified portfolio manager (Exh. EDA-1, at 18-19; Exh. KED-DTE-1-5; Exh. KED-DTE-1-10; Tr. at 34-36). If KeySpan is situated to "step into the shoes" of the asset manager in the event of a default or lack of available asset managers, KeySpan will have the flexibility necessary to ensure the overall reliability of the resource portfolio (Tr. at 34-35, 38). From the Company's perspective, this flexibility will provide the Company with three basic alternatives for managing the resource portfolio in the future given market conditions and other relevant considerations: (1) to enter into a traditional outsourcing arrangement; (2) to bring management of the portfolio in-house without the assistance of an asset manager; and (3) to enter into a cooperative relationship that balances reliability with revenue optimization (Exh. KED-AG-1-19; Tr. at 38). The development of additional staffing and expertise will allow KeySpan the flexibility to be prepared to procure and manage needed resources on a permanent basis (if necessary and in the best interests of customers), while achieving a high level of value for asset optimization activities for the benefit of customers. Therefore, the proposed Asset Optimization Agreement will enable the Company to achieve a position where all three of these options are open and available to serve the best interests of customers.

In that regard, the record shows that the Company's existing staff and in-house resources have experience, and actively participate, in: (1) long-term and short-term planning and forecasting activities; (2) procurement of long-term capacity and supply resources for addition to the portfolio consistent with the planning activities; and (3) management of on-system peaking assets and related supply and operational issues (id.). In terms of portfolio optimization, existing staff in Massachusetts has experience with relatively basic gas transactions, but are not as experienced in executing more complicated financial transactions and procurement strategies (Exh. EDA-1, at 19). In addition, although there are KeySpan staff in New York who have substantial experience in managing the New York portfolio, specific expertise with the Massachusetts portfolio is needed because of the differences in the portfolios and characteristics of the service territory. Among other examples, the record shows that there are six gate stations in New York and 48 in New England; a much greater dependency on LNG in New England and a higher level of system constraint in New England (Exh. KED-AG-1-12; Tr. at 68-70). These differences require specialized expertise relating to the Massachusetts portfolio.

The Company reached the determination that additional in-house capability was needed to maintain flexibility and reliability based on its recent experience with the RFP process and events that transpired over the fall in the market for natural gas (Exh. EDA-1, at 15-17; Exh. KED-DTE-1-5; Exh. KED-DTE-1-10). Specifically, when the Company issued the RFP associated with the EKT Agreement in 2003, the Company solicited bids from seven potential bidders and received only four bids (Exh. EDA-1, at 16). Of these four bidders, only one bidder (EKT, now operating as MLCI) remains in business and elected to participate in the RFP solicitation conducted by the Company in June 2005 (id.). Although KeySpan's experience with MLCI has been favorable and MLCI's management of the resource portfolio has enhanced its value to the benefit of customers, the Company's experience with the two most recent RFP processes has made it clear to the Company that the market for asset optimization services has changed dramatically (id.). Therefore, the proposed Agreement will preserve the Company's flexibility to manage the portfolio in the absence of an available and creditworthy asset manager, which in turn, will preserve the reliability of the overall resource portfolio. Accordingly, the Department should find that the proposed Agreement is consistent with the Company's portfolio objectives.

2. Comparison with Reasonably Available Alternatives

With respect to the second part of the Department's standard, the Department found in D.T.E. 04-9 that the EKT Agreement represented the highest possible value for customers based on portfolio and market conditions at the time KeySpan entered the contract. D.T.E. 04-9, at 11. In addition, the Department found that customers would not pay more for their gas supplies than they would have absent the EKT Agreement because of the pricing hierarchy. Given the benefits to customers in the form of the guaranteed fee, as well as any additional revenues derived from the sharing of excess revenues, the Department further found that customers were likely to experience an overall net benefit. D.T.E. 04-9, at 12.

In this case, the Company has demonstrated that the Asset Optimization Agreement provides the highest market value available as a co-management agreement (see, e.g., Exhibit KED-AG-1-2(supp.)(confidential)). The Asset Optimization Agreement would operate in the same manner as the existing EKT Agreement in terms of the price to be charged to customers through the CGA for gas supplies. By application of the pricing hierarchy, customers will not pay more for their gas commodity than they would have absent the Asset Optimization Agreement. In addition, the fixed costs of the portfolio assets paid by customers will be mitigated by the guaranteed minimum payment, as well a share of the revenues achieved over and above the minimum payment (without the need to share those revenues with KeySpan as they do under the EKT Agreement). Therefore, the Asset Optimization Agreement represents the highest possible value for customers in light of current market conditions and the need to meet critical portfolio objectives (reliability, flexibility and diversity of supply). Accordingly, the proposed Agreement compares favorably to current market offerings considering price and non-price factors. Therefore, the Department should find that the proposed Agreement is consistent with the public interest.

C. Allocation of Revenues Generated Under the Agreement

The record shows that, under the co-management arrangement with MLCI, KeySpan will share the risk associated with the payment of the minimum amount to customers, which is not a feature of the existing arrangement (Exh. EDA-3, at Article VI; Tr. at 13-14). In addition, the record shows that the Company anticipates that there would be in the range of $500,000 to $2.0 million in incremental costs for staffing, training and systems development and maintenance in order to develop the capability to backstop the Massachusetts resource portfolio (Exh. KED-DTE-1-4; Exh. KED-DTE-1-8; Exh. KED-AG-14). As proposed, however, there would be no additional cost to customers because any incremental costs incurred by the Company would be mitigated through the revenue-sharing arrangement with MLCI (Exh. KED-DTE-1-4; Tr. 74-75).

As stated by the Department in D.T.E. 04-9:

> In D.P.U. 93-141-A at 59, the Department acknowledged that the regulatory policy of requiring all margins derived from capacity-management tools (i.e., interruptible sales, capacity release, interruptible transportation, and off-system sales) to flow to firm customers can result in a disincentive for LDCs to make investments that are in the public interest. As a result, the Department has accepted revenue-sharing arrangements as a mechanism to improve efficiency and, ultimately, to produce cost savings to customers. Id., citing Incentive Regulation, D.P.U. 94-158, at 47-52 (1995).

D.T.E. 04-9, at 13. In this case, application of the Department's traditional margin-sharing policy under D.T.E. 93-141-A will serve as a disincentive to the Company's investment in the management of the resource portfolio and acceptance of risk on behalf of customers.

However, the Company testified that it is not seeking a change in the margin-sharing policy set forth in D.P.U. 93-141-A (Tr. at 17). Rather, the Company is proposing that the Department approve the proposed Agreement and allow the Company to share in the revenues generated by the arrangement in excess of the minimum payment based on an allocation that differs that falls outside of the D.P.U. 93-141-A framework. Under the proposed arrangement, KeySpan would share in the revenues that MLCI would have otherwise retained. Therefore, customers would receive a higher allocation of revenues than the existing agreement (because the customer portion is not shared with KeySpan); MLCI would receive a smaller portion of the revenues exceeding the fixed payment, and KeySpan would receive a larger share of revenues exceeding the fixed payment in consideration of the higher level of risk and cost that would be incurred by KeySpan under the arrangement (RR-DTE-1).

The Company testified that treatment outside of D.T.E. 93-141-A is necessary and warranted for three primary reasons: (1) because it will enable the Company to enter into an arrangement with MLCI to gain expertise by working with them and co-managing the portfolio; (2) because, as a co-manager, KeySpan will be taking on additional risk in guaranteeing a portion of the fixed, minimum payment and entering into transactions designed to achieve value for the portfolio resources; and (3) because KeySpan will incur incremental costs to meet the reliability needs of the overall resource portfolio (Tr. at 54-56). The co-management arrangement provides the incentive for a cooperative relationship that balances reliability with revenue optimization, which is beneficial for all interests involved. Therefore, the Department should find that KeySpan's proposed revenue sharing allocation is in the public interest and is approved.

IV. CONCLUSION

Accordingly, after due notice, hearing and consideration, the Department should:

<u>ORDER</u>: That the Asset Optimization Agreement between MLCI and KeySpan Energy Delivery New England is approved; and it is

<u>FURTHER ORDERED</u>: That KeySpan Energy Delivery New England shall follow all other directives in the Order.